SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1940

No. 402

MAIN AND McKINNEY BUILDING COMPANY OF HOUSTON, TEXAS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

To the Honorable Supreme Court of the United States:

Petitioner, Main and McKinney Building Company of Houston, Texas, in this petition for writ of certiorari to the Circuit Court of Appeals for the Fifth Circuit, respectfully presents the following:

I.

Statement of the Case.

The facts were stipulated (R. 23-27), and are substantially as follows:

Petitioner was incorporated under the laws of Texas on October 5, 1925, and has its principal place of business at Houston, Texas (R. 23).

The calendar year is the accounting period used by petitioner (R. 23).

On March 12, 1926, by a contract of that date, petitioner acquired from Main Realty Company the unexpired term of a lease on property at Main Street and McKinney Avenue in Houston, Texas (R. 23). The lease was originally executed to Main Realty Company, as lessee, on or about April 3, 1925, by Binz & Settegast (R. 14) and expires April 1, 2024 (R. 24). Petitioner agreed in the above mentioned contract to pay Main Realty Company the sum of $60,547.30 in cash (R. 14), and further agreed therein (a) "*to pay the rents* and all other payments, taxes, assessments, levies, and governmental charges of all and every kind as specifically and generally set out and described *in the lease from Binz & Settegast* and required to be paid by lessee in said lease"; and (b) to pay Main Realty Company "*as additional rent*" the sum of $10,000 per year for twenty-five years beginning September 1, 1926 (Italics ours R. 15).

The lease from Binz & Settegast referred to above (R. 15) provided for the payment of rentals as follows:

> "$12,500 per year for the first and second years, beginning April 1, 1925; $25,000 per year for the next five years; $30,000 per year for the next eighteen years; $35,000 per year for the next twenty-five years; and $45,000 per year for the remaining forty-nine years of the lease term."

The contract of March 12, 1926, which petitioner contends and respondent finally admitted was a sublease, further provides that in event of default by petitioner in the discharge of any of its obligations therein created or assumed, Main Realty Company would have the right to "reenter the demised premises and take full and complete possession thereof and of the improvements upon the demised premises, or any part thereof." (R. 16-17.)

In each of its tax returns for the years 1926 to 1935 inclusive, petitioner deducted the $10,000 annual payments as rent and as an operating expense (R. 25-26). Respondent accepted and approved petitioner's returns for the years 1926 to 1932 inclusive, and allowed the deduction in each of said returns of the $10,000 item without question (R. 25-26).

In 1933, respondent excepted to the $10,000 deduction and capitalized the item. Because of the remission by respondent of certain substantial items in dispute, petitioner paid in compromise the assessment for 1933 on the $10,000 item, but without prejudice to its claim that the assessment was unauthorized (R. 26).

Respondent refused to allow the deduction of the $10,000 item as an operating expense in petitioner's returns for 1934 and 1935, and thereupon assessed deficiencies in the taxes paid by petitioner for those years as follows (R. 32):

In 1934—	
Income tax deficiency	$1,341.99
Excess profits tax deficiency	436.20
In 1935—	
Income tax deficiency	$1,326.71
Excess profits tax deficiency	353.44

Petitioner contends that the $10,000 annual payments were "additional rent" that petitioner was required to pay to Main Realty Company, as expressly agreed and provided in the sublease, and as such were deductible in the years during which they were paid; that such rental payments were in addition to those that petitioners assumed and agreed to pay annually to Binz & Settegast under the original lease; that petitioner agreed to pay the $10,000 additional rentals to Main Realty Company because petitioner and the Realty Company in their sublease considered the rental value of the property for the first twenty-five years

to be $10,000 a year more than the annual rentals that petitioner was required to pay under the original lease for the corresponding period.

Respondent contended before the Board of Tax Appeals that the payments in question were not rentals at all; that the contract of March 12, 1926 was not a sublease but a sale or assignment; that the payments were a part of the purchase price and as such should be recovered only by ratable deductions over the entire term of the lease. The Board of Tax Appeals in its memorandum opinion filed August 25, 1939, sustained respondent's contention and held that the contract "was one of sale and was not a sublease." (R. 33.)

But in the Circuit Court of Appeals, respondent was confronted with the decision of the Supreme Court of Texas in *Davis* v. *Vidal*, 105 Tex. 444, 151 S. W. 290. This case was not cited by petitioner in the hearing before the Board of Tax Appeals for the reason that petitioner did not find the case until later when preparing its brief in the Circuit Court of Appeals. The court in the *Davis* case conclusively held that the mere reservation by the lessee in the original lease of a right of re-entry in an instrument transferring the lease will constitute the transfer a sublease and not an assignment, even though the entire unexpired portion of the term is transferred. With reference to this case, respondent in the footnote on pages 12-13 of his brief, said:

> "* * * The rule followed by many, if not the majority, of the courts is that the mere reservation of a right of re-entry where the lessee has otherwise transferred the entire unexpired portion of the term does not constitute the retention of such a reversionary interest as will classify the transfer as a sublease. * * * (citing cases). *The rule seems, however, to be to the contrary in Texas.* Davis *v.* Vidal, 105 Tex. 444, 151 S. W. 290. * * *." (Italics ours.)

Respondent thereupon abandoned his original theory and then contended in the Circuit Court that the payments,

if rentals, were advance rentals and should be treated the same as though they constituted the consideration for a sale or assignment of the lease, recoverable as such only by ratable deductions. There is no evidence whatever in the record relating to the character of the payments in dispute other than that set out above. (See entire Stipulation of Facts, R. 23-27.) The Circuit Court of Appeals, notwithstanding, in its opinion filed July 3, 1940, adopted this latter contention of respondent and held that the payments, if rentals, were advance rentals, recoverable only by ratable deductions over the entire term of the lease (R. 43).

Petitioner duly filed its petition for rehearing on July 24, 1940 (R. 45), which was overruled without a written opinion on August 2, 1940 (R. 57).

An application for a stay of the mandate of the Circuit Court of Appeals to enable petitioner to apply for and obtain a writ of certiorari from this Honorable Court was filed August 13, 1940, and granted the same day (R. 57, 60).

Petitioner is relying herein on the first four of the five Specifications of Error presented in its petition for rehearing in the Circuit Court of Appeals (R. 46-47).

II.

Questions Presented.

1. Was the Circuit Court of Appeals correct in holding the two $10,000 payments in question were advance rentals and not current rentals under these circumstances:

(a) Respondent in the Stipulation of Facts and in presenting his case to the Board of Tax Appeals relied solely on the theory that the contract of March 12, 1926 was a sale or assignment and not a sublease, and that the payments were therefore a part of the purchase price and not rentals; he did not even attempt to offer evidence in support of any other theory, and there is none.

(b) The Board of Tax Appeals adopted petitioner's theory and rested its decision entirely thereon, holding that the contract in question "was one of sale and not a sublease".

(c) Respondent when confronted in the Circuit Court of Appeals with the holding of the Supreme Court of Texas in the *Davis* case, *supra,* that contracts such as the one in question are subleases and not assignments, stated in his brief filed in that court (pages 12-13) that "the rule followed by many, if not the majority, of the courts" is that such contracts cannot be considered as subleases, but that "the rule seems, however, to be to the contrary in Texas," citing the *Davis* case; respondent thereupon abandoned his original theory that the payments were not rentals at all, and contended that if they were rentals, they were advance rentals that should be treated the same as though they constituted a part of the purchase price of the leasehold.

(d) The Circuit Court of Appeals then adopted the latter contention of respondent and held, without evidence to support the holding, that the payments, if rentals, were advance rentals recoverable only by ratable deductions over the term of the lease.

2. Was the Circuit Court of Appeals correct in holding that the two $10,000 payments were advance rentals when all of the evidence in the record relating to the character of those payments will support petitioner's contention that they were simply additional current rentals for the years in which they were paid and deductible as such?

3. Was the Circuit Court of Appeals correct in holding that "the error of petitioner's theory is made apparent" by the fact that if such theory were correct and the $10,000 payments were current rentals, then "the payment thereof at a specified rate entitled petitioner to the use of the prem-

ises for a period of seventy-three years without paying any rent therefor," when petitioner was required to pay in that period a much larger annual rental than in any other, and in fact, was obligated to pay a rental of $45,000 per year for the last forty-nine years thereof?

4. Is the decision of the Circuit Court of Appeals in conflict with the decision of the Supreme Court of Texas in *Davis* v. *Vidal, supra?*

III.

Jurisdiction and Reasons Why the Writ Should Be Granted.

No Federal question is involved in this case authorizing appeal or writ of error under Title 28, U. S. C. A., Section 347 (Judicial Code, Section 240 amended). Under that statute and under Rule 38, Subdivision 5, promulgated by the Supreme Court on February 27, 1939, this Honorable Court has jurisdiction to issue a writ of certiorari and should issue such writ, for the following reasons:

(1) The judgment herein sought to be reviewed was rendered July 3, 1940 (R. 42) and petitioner's application for a rehearing was overruled on August 2, 1940 (R. 57).

(2) The Circuit Court of Appeals held that the two $10,000 payments in question were advance rentals, to be treated, however, as though they were a part of the purchase price rather than rentals, with no evidence before it as to the character of those payments other than the evidence afforded by the contract of March 12, 1926, and the original Binz & Settegast lease therein referred to. Such evidence, though, provides no support whatever for the view that the payments were advance rentals, but on the contrary, necessitates the view that they were current rentals and not advance rentals. Hence the only support

the Circuit Court of Appeals could have found for its decision was in what it considered to be the legal effect of the contract of March 12, 1926, particularly and solely in the fact that such contract vested in petitioner the title to the entire unexpired term of the lease, though Main Realty Company reserved the right of re-entry in event of default.

In this view, the Circuit Court affirmed the judgment on the same ground on which the case was decided by the Board of Tax Appeals, to-wit, that where the entire unexpired term of a lease is transferred to another, the transaction is the equivalent of a sale or assignment and not a sublease, regardless of the agreement of the parties, or the terms of the instruments affecting the transaction, or any other fact or circumstance; and the decision of the Circuit Court of Appeals is therefore directly in conflict with the decision of the Supreme Court of Texas in *Davis* v. *Vidal, supra* (Brief, p. 15).

(3) Even if it should be considered that the decision of the Circuit Court of Appeals is not in conflict with the decision of the Supreme Court of Texas in the *Davis* case, *supra,* the Circuit Court in holding that the payments in dispute were advance rentals recoverable only by ratable deductions over the entire term of the lease, has (a) erroneously decided an important question of general law; (b) decided an important question of Federal law which has not been, but should be, settled by this Honorable Court; and (c) departed from the accepted and usual course of judicial proceedings, and sanctioned such a departure by a lower court, to such an extent as to require the exercise of the supervisory powers of this Honorable Court, all for the following reasons:

a. When petitioner and Main Realty Company executed the contract of March 12, 1926, they considered the rental value of the property for the next twenty-five years to

be $10,000 a year more than the annual rentals required in the original lease for the corresponding period, and they accordingly agreed and contracted that petitioner should pay Main Realty Company $10,000 per year as "additional rent" during that period. The $10,000 annual payments, we submit, were therefore unquestionably additional current rentals for the years in which they were paid, and deductible as such (Brief, pp. 21-23).

b. There is not a scintilla of evidence in the record of this case that the $10,000 payments in question were advance rentals (Brief, p. 21).

Wherefore, petitioner prays that this Honorable Court will issue a writ of certiorari herein and reverse the judgment.

Respectfully submitted,

MAIN AND MCKINNEY BUILDING COMPANY OF HOUSTON, TEXAS,
Petitioner,

By EDWARD S. BOYLES,
Its Attorney.

WILLARD L. RUSSELL,
Of Counsel.